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Bell Atlantic

Bell Atlantic Network Services, Inc
1133 20th Street, N.W
Suite 810
Washington, DC 20036
202 392-1189
FAX 202 392-1369

Maureen Keenan
Director - FCC Relations

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June 2, 1994

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

EX PARTE

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

RE: CC Docket No. 93-179

Today, on behalf of the Ameritech, Bell Atlantic, Bell South, GTE, Lincoln, Pacific Telesis Group, Rochester, Southwestern and US West Telephone Companies, Dave Sorenson (Ameritech),Jim Harvey (Bell Atlantic), Mike Crumling (US West) and I met with A. Richard Metzger, Acting Chief, Common Carrier Bureau, David Nall, Deputy Chief, Tariff Division, JoAnn Wall, Tariff Division, and Thad Machcinski, Accounting and Audits Division to discuss the above referenced proceeding.

Please include this letter and its attachments as part of the record of this proceeding.

Sincerely,

Maureen Keenan

Attachments

cc: R. Metzger
D. Nall
J. Wall
T. Machcinski

No. of Copies rec'd 0+1
List ABCDE

1992–1993 Price Cap Tariff Filings and the Add Back Notice of Proposed Rulemaking 93–179

Delegation of Price Cap LECs

Ameritech
Bell Atlantic
BellSouth
GTE
Lincoln Telephone
Pacific Bell
Nevada Bell
Rochester Telephone
Southwestern Bell
US West

Add Back Overview

Part 65 and the Price Cap Orders Contain No Provisions Mandating Adjustment of Form 492 Interstate ROR Results for:

- o Exclusion of Lower Formula Adjustment Revenues
- o "Add Back" of Price Cap Shared Revenues

Add Back Would Represent a Fundamental Price Cap Policy Change and Rules Change

FCC Indicated in its Price Cap Orders that the Sharing Mechanism was not Intended to Replicate the Commission's Earlier Rate of Return Refund Provisions

Lag in Returning the Benefit of the Sharing to Customers is Addressed by the Application of Interest on Sharing (April 17, 1991 Price Cap Order on Reconsideration, footnote 157)

Add Back Can Only Be Applied on a Prospective Basis

Sharing and the Lower Formula Adjustment Mechanisms Should Be Addressed in the Broader Regulatory Policy Context of the Price Cap Comprehensive Review

FCC Ordered Refunds vs. Price Cap Sharing

FCC Ordered Refunds	Price Cap Sharing
Refunds Ordered by the FCC for Violation of the ROR Prescription	Price Cap Rules Require a Prospective Pricing Adjustment to Rates if a LEC Exceeded the FCC Productivity Benchmark
Add Back of FCC Ordered Refunds in Form 492 Reporting was used as a "Report Card" to Check LECs for Violation of the Rate of Return Prescription	
LECs Were Required by the Commission to Annually Retarget Rates Within the FCC Allowable Rate of Return Ceilings Based on: Demand Forecasts Exogenous Costs Changes Endogenous (Operating) Costs Changes	No Requirement to Retarget Basket PCIs and Rates Based on Endogenous (Operating) Cost Changes

FCC Ordered Refunds vs. Price Cap Sharing

FCC Ordered Refunds	Price Cap Sharing
Add Back of FCC Ordered Refunds Did Not Trigger Additional Refunds	Sharing Was Intended As a One-Time Adjustment to Basket PCIs snd Rates
	Add Back of Sharing Triggers Additional Sharing on Sharing
	Add Back Would Extend Sharing Beyond Being a Temporary, 12-Month Pricing Adjustment of PCIs and Rates
ROR Enforcement Mechanisms include: FCC Show Cause Action Complaint Proceedings FCC Tariff Filing Disallowances	Under Price Cap Regulation, Complaints for Excessive Earnings in Relationship to Costs Will Not Lie With the Commission (FCC Price Order, para. 128)
FCC Refunds Ordered Were Fixed Amounts Based on Specific Refund Liability Calculated From a Reported ROR in the Form 492	Amounts Shared Are Not Fixed Amounts But Rather Are Based on the Relationship of Basket APIs vs. PCIs

Illustrative Examples

Without Add Back of Sharing

	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5
Earned Revenues	$2,655	2,630	2,618	2,618	2,618
Expenses and Taxes	2,100	2,090	2,096	2,096	2,096
Net Income	555	540	522	522	522
Rate Base	4,300	4,300	4,300	4,300	4,300
Rate of Return	12.90%	12.56%	12.14%	12.14%	12.14%
Price Cap 50% Sharing Based on Previous Year's ROR	--	($25)	($12)	$0	$0

With Add Back of Sharing

	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5
Earned Revenues	$2,655	2,630	2,630	2,630	2,630
Add Back of Sharing	0	25	25	25	25
Adjusted Revenues with Add Back	2,655	2,655	2,655	2,655	2,655
Expenses and taxes	2,100	2,100	2,100	2,100	2,100
Net Income	555	555	555	555	555
Rate Base	4,300	4,300	4,300	4,300	4,300
Rate of Return	12.90%	12.90%	12.90%	12.90%	12.90%
Price Cap 50% Sharing Based on Previous Year's ROR including Add Back of Sharing	--	($25)	($25)	($25)	($25)

Add Back Extends Sharing Beyond Being A Single Year's One–Time Adjustment

Disincentive of Add Back

Without Add Back	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5
50/50 Sharing	$0	($25)	($12)	0	0
Cumulative Sharing	$0	($25)	($37)	($37)	($37)
With Add Back					
50/50 Sharing	$0	($25)	($25)	($25)	($25)
Cumulative Sharing	$0	($25)	($50)	($75)	($100)
Add Back Disincentive	**$0**	**$0**	**($13)**	**($38)**	**($63)**

Add Back of Sharing Artificially Triggers Additional Sharing on Unearned "Hypothetical" Revenues

Add Back Undermines the Productivity Incentives Under Price Cap Regulation and Inflates the Disincentive of a Sharing Requirement

ADD BACK ANALYSIS

The fastest way to understand the impact of add back on price cap regulation is to utilize a very simplistic model which focuses only on sharing and price reductions. The attached analysis depicts such a model in which the volumes of sales, the expenses and the net investment are held constant. Also, the GNPPI is set equal to the productivity factor so as to eliminate any price change effects due to other sources. The model ignores such timing restraints as the mid-year implementation of rates and treats the tax implications by acknowledging that price reductions are, in fact, greater than the sharing amounts depending on the tax rate. The model follows price cap rules in that sharing reductions implemented at the beginning of the year are reversed out at the end of the year, and any new sharing amounts are then applied as reductions to revenues.

The resultant analysis shows that a $20 million sharing amount in the base year would result in a permanent price reduction greater than $20 million annually rather than the one time benefit intended in the price cap order. The model also shows that, even without add back, customers would receive continuing benefits from the initial sharing amount. The analysis also demonstrates the application of add back under the rate of return model and why it was necessary under that form of regulation.

Analysis of Add Back

Assumptions:

To isolate impact of Add Back, the following factors remain constant:

Volumes (Quantities of Sales)
Expenses
Net Investment (i.e. "Rate Base")
GNPPI = Productivity Factor
(i.e. no change in PCI due to GNPPI & productivity factor)

With Add Back (Exhibit 1)

Base Year Net Income \$40M over Sharing Threshold = \$20M Sharing Reduce prices per Base Year quantities to produce revenue reduction >\$20M because of tax effect. Result: Customers get same services as in Base Year for >\$20M less I.E. Customers have received the one time price reduction benefit provided for in the price cap order.

At end of Base Year +1, net income will be \$20M over Sharing level as intended; that is, prices were reduced enough to result in a \$20M reduction in net income. All other things being equal the Company was \$40M over in Base Year (BY) and is now \$20M "over" in BY+1. With Add Back, a fictitious \$20M would be added to net income for a total of \$40M over the Sharing Level resulting in another Sharing amount of \$20M to be reflected in price reductions for BY+2.

This produces two anomalous results. First, customers get another >\$20M price reduction contrary to the "one time" intent of the price cap order. Second, the actual net income received by the Company in BY+1 was only \$20M over the Sharing Level. Therefore, the Company is now sharing 100% of the net income received over the Sharing Threshold contrary to the 50% sharing intended in the price cap order. Consequently, the incentive to reduce expenses is diminished.

This result would continue year after year -- all other things being equal per the assumptions. Thus, customers would get a permanent price reduction of >\$20M instead of a "one time" adjustment and the Company would be forced to share 100% of net income over what was supposed to be the 50% Sharing Threshold.

Without Add Back (Exhibit 2)

Even without Add Back, the customer gets additional benefit through sharing. Using the same scenario without Add Back, there would still be a sharing amount of $10M resulting from BY+1 net income of $20M over the sharing level. Thus, prices in BY+2 would be lower than the Base Year by >$10M.

In fact, even without Add Back, customers would still receive continuing price reductions (beyond the one time reduction of >$20M) that would approximate 2/3 of the reductions with Add Back. The main difference is that the price reductions (Sharing amounts) would be based on 50% of actual net income received over the Threshold and not some fictitious inflated amount.

Rate of Return (Exhibit 3)

Under Rate of Return regulation, if a Company earns $40M over the "hard" cap for RoR, it is required to refund the entire $40M by adjusting prices in the following year to retarget to a RoR that would be $40M below the authorized RoR. This is due to the fact that the Company has already received $40M more than the maximum it was authorized to earn in the Base year.

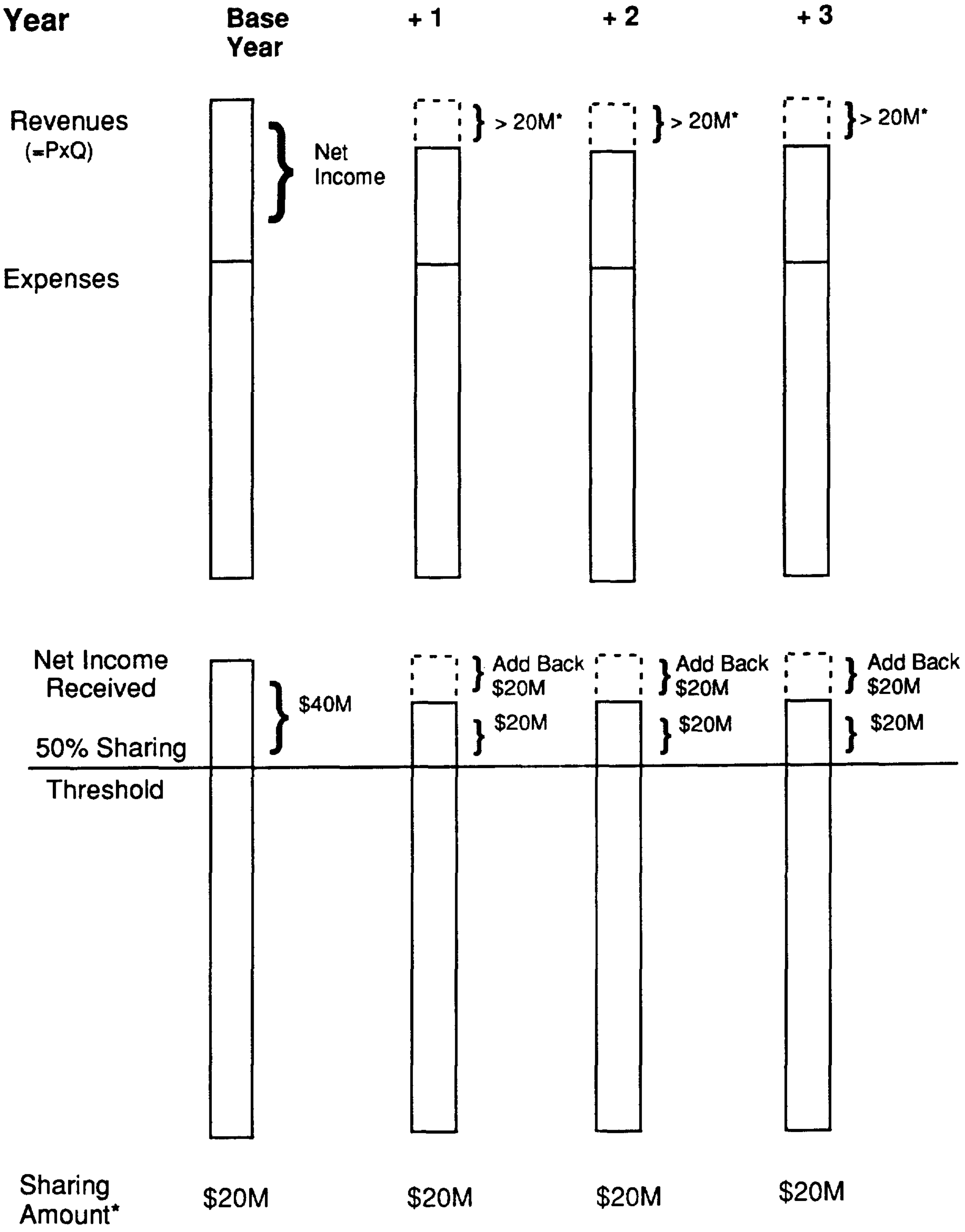
Adding in the $40M overearnings received in the Base Year to the retargeted rates in Base year +1 would result in the authorized RoR being earned in Base year +1. The Company could earn another 25 basis points in Base Year +1 before triggering another refund.

Under RoR, there is no incentive to reduce expenses in any year beyond the 25 basis point 'grace' buffer. Because price cap is an incentive plan rates are not retargeted each year. The customer gets the benefit of the sharing in a one time price adjustment.

Under price cap, there is an incentive to reduce expenses until the Company reaches the 100% sharing level although the incentive is reduced at the 50% sharing threshold. With Add Back, this incentive reduction occurs at a point less than the 50% Sharing Threshold by the amount of the Add Back.

Exhibit 1

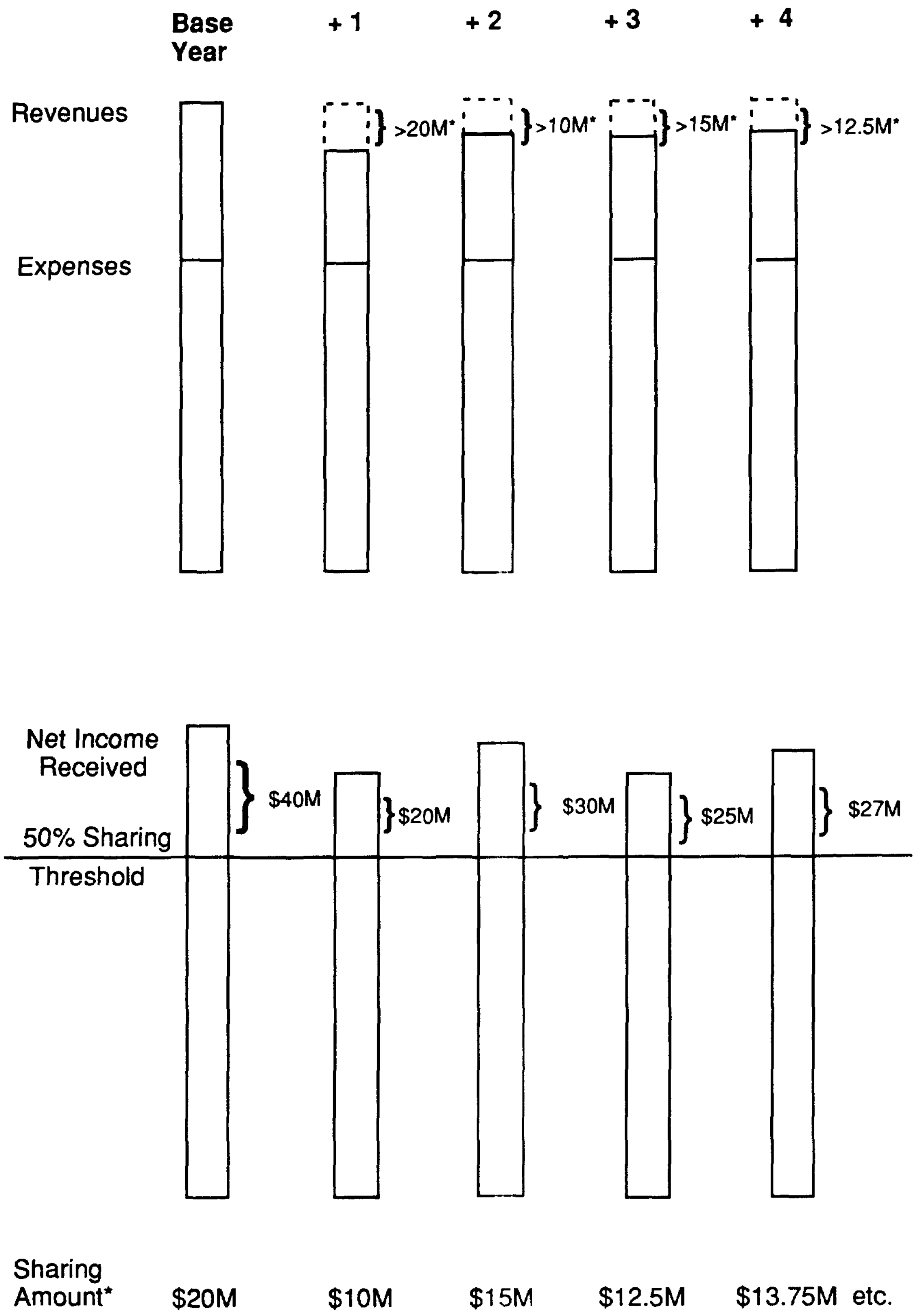
With Add Back



* Actual price reduction in the following year would be greater than the sharing amount due to tax effects. E.g., at a 50% tax rate the price reduction would be double the sharing amount.

Exhibit 2

Without Add Back



* Actual price reduction in the following year would be greater than the sharing amount due to tax effect. E.g., at a 50% tax rate, the price reduction would be double the sharing amount.

Exhibit 3

Rate of Return